HELP ?

Foreign direct investment in developing countries: Progress and problems

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Abstract:
*Many developing countries have made notable efforts to attract **foreign direct investment** in the past decade. Although total flows to the developing world have exploded, they are unevenly distributed. Countries that have aggressively reformed policies have been far more successful than countries whose reforms have been half-hearted. Problems of the less successful countries include: 1. obstacles to entry, 2. inadequate legal protection, 3. overvaluation and restricted access to hard currencies, 4. trade barriers, 5. tax distortions, and 6. getting the word out.*

Full Text:
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Foreign direct investment (FDI) is playing a growing role in economic development. FDI flows to the developing world quadrupled from an annual average of $12.6 billion in 1980-85 to $51.8 billion in 1992-93, and rose to $70 billion in 1994. Developing countries received 32 percent of total world FDI during 1992-94, up from 20 percent in the first half of the 1980s. The share of FDI in the gross capital formation of developing countries more than doubled between 1986 and 1992, surpassing 6 percent in 1993.

While FDI is surging, other forms of capital flows to developing countries are diminishing (see table). (Table omitted) Aid has continuously declined as a share of capital inflows since the 1960s, when it was the most important source of external finance for developing countries; it now accounts for only one fourth of their capital inflows. Commercial loans, a major source of capital flows in the 1970s, have virtually disappeared since the debt crisis of the 1980s. Portfolio investment, which boomed when stock markets in developing countries caught the attention of investors in the 1980s, is important but is also volatile and risky--as demonstrated by outflows from Mexico in December 1994.

Unlike other forms of capital inflows, FDI almost always brings additional resources-technology, management know-how, and access to export markets--that are desperately needed in developing countries. Investors are exacting, however, when it comes to deciding which countries are the most desirable sites for investment, and the lion's share of FDI has been going to a handful of countries, mostly in East Asia and Latin America (see chart). (Chart omitted) In 1994, 11 countries accounted for about 76 percent of total FDI flows to the developing world. Nevertheless, some small countries (including many island countries) have received amounts of FDI that are large in proportion to the size of their economies. But FDI flows to many other countries, particularly in sub-Saharan Africa, have stagnated.

Why East Asia and Latin America?

More and more developing countries have reduced barriers to FDI and improved their business climates. At the same time, multinational corporations are responding to increased competition by considering a broader range of locations for their facilities. These mutually reinforcing trends have combined with technological changes in communication, transportation, and production to make "the global marketplace" a reality for investment decisions. The days of producing shoddy, high-cost products for sale in local markets are passing; most foreign investors are interested only in sites where they can produce to international standards of quality and price.

This globalization means that the old distinction between export-oriented production and production destined for the local market is weakening and even disappearing. Countries that want to develop must offer good business conditions both for exporters and for production for local markets. The emphasis may differ, depending mainly on the size of the local market, but providing the combination is increasingly important. Countries in East Asia and Latin America have received the most FDI because they have adjusted their strategies to keep up with globalization.

Some of these countries initially based their development on exporting labor-intensive manufactured goods to the industrial countries. Recently, many have recognized that technological advances and intensified competition have increased the capital and skill intensity of production in many industries. This means that countries can no longer count on low labor **costs** alone but also need high. quality, productive labor to sustain their comparative advantages. Those that have succeeded in attracting FDI have focused on improving general education, industrial skill training, and labor and managerial discipline. Facilitating companies' efforts to upgrade technology has also been crucial in maintaining their competitive edge.

The development of other successful countries was initially based on import-substituting industrialization. This strategy produced valuable skills, institutions, and physical infrastructure, but was inherently limited because of small domestic markets and the inefficiencies caused by continuing protection. These countries were either forced by economic crises or inspired by countries that succeeded through more outward-looking policies to reduce protection, privatize state enterprises, and make their productive apparatus competitive internationally.

Whatever route they took, the rapid, sustained economic growth of the successful countries of East Asia and Latin America has earned them the name "emerging markets." They are even beginning to rival the industrial countries as export markets because of strong, consistent increases in the demand for consumer goods and services. All this has made them extremely attractive to international investors.

Companies interested in establishing facilities in emerging markets need access to quality supplies of parts, components, and supporting services. For manufacturing industries, especially, a major force driving success is a "flexible" system of intercorporate relations under which companies specialize in different stages of production, either upstream or downstream in a production chain, and cooperate closely with each other through networking and long-term buyer-supplier relationships. This type of system helps integrate foreign investment into host economies and allows the latter to derive more benefit from FDI through induced economic activities, the transfer of technology and management skills, and better access to export t markets. But companies need great flexibility and highly developed skills to ensure "just-in-time" delivery of quality intermediate goods and services, without defects. Countries that have the conditions that facilitate these kinds of operations have become much more competitive in the eyes of foreign investors.

None of the countries that have attracted significant FDI inflows could have done so without sustained trade reform enabling them to keep up with the pressure of international competition. All have carried out substantial domestic economic reforms to encourage private sector development. Many have essentially succeeded in stabilizing the macroeconomic environment, reducing price distortions, deregulating investment procedures, and increasing general economic effciency--getting the "fundamentals" right for all private investment, domestic and foreign.

What about other countries?

Many other developing countries have also embarked on reforms, addressing the same issues--fiscal and monetary imbalances, price distortions, bloated public enterprises, and unnecessary regulations, among others. Many have made significant progress, winning deserved praise from economists, banks, and international institutions, including the World Bank and the IMF. But FDI has either not appeared or, if it has, still falls short of the amount desired. What is wrong?

One basic problem is that some countries possess few attractions for foreign investors. One traditional attraction of developing countries--cheap labor--is becoming less important in investment decisions. Economies at an early stage of industrialization do not offer the sophisticated providers of inputs--both goods and business services-that most foreign investors need to be competitive. Another factor that deters investment is poor economic performance--FDI tends to follow growth, not to lead it.

A closer look at the less successful countries, however, reveals that many that are potentially attractive to FDI simply have not carried their reforms far enough. Foreign investors do not come just because some progress has been made; to attract FDI, countries must have made enough progress to meet worldwide best-practice standards.

Obstacles to entry. Many countries have liberalized entry policies over the past few years. They have relaxed restrictions on foreign ownership and entry in certain sectors, and they have also introduced "negative lists" to limit the types of investments that require screening and approval. In many countries, however, entry is still needlessly restricted and/or arbitrarily regulated-often because of pressure from domestic interest groups or from regulatory authorities with vested interests in screening.

Inadequate legal protection. Most governments have recognized the need for investment protection, and many have guaranteed equal treatment for foreign and national investments. An increasing number of countries have enacted laws forbidding expropriation or guaranteeing prompt and adequate compensation in the event of expropriation. In more and more countries, foreign investors have recourse to international arbitration for settling investment disputes.

Legal reforms are still far from adequate in most countries, however. In many cases, laws still implicitly allow expropriation of investors' property for arbitrary reasons. The very poor functioning of judicial systems in many countries calls into question the "prompt and adequate compensation" promised by law. Finally, investors are often required to exhaust domestic means for settling disputes before resorting to international arbitration. In the context of a weak domestic court system, this dramatically weakens investors' confidence

Overvaluation and restricted access to hard currencies. Since the late 1980s, a growing number of developing countries have taken steps to liberalize their foreign exchange systems. Many have devalued their currencies, and some have allowed market determination of the exchange rate. In spite of considerable adjustments, however, many currencies are still overvalued, and extensive controls on exchange transactions are still seen as necessary. Moreover, foreign exchange liberalization in many countries has been accomplished by decree but not followed up by appropriate legislative steps, creating an atmosphere of uncertainty for investors.

Trade barriers. In the past, many developing countries that had adopted an import. substitution strategy attracted FDI by offering investors a protected domestic market. Recognizing the importance of competing in global markets, most have now reduced protection and taken steps to promote exports. In too many instances, however, trade reforms have still not gone far enough. Some countries have reduced protection significantly, but still have too much to foster real competition at home or to provide an exchange rate that is conducive to exports. There is also a widespread problem in the developing world with customs services. Better trade policies may be negated by bureaucratic customs procedures and the obstructionist attitude of cuss, toms agents. Thus, imported capital equipment and other inputs do not arrive at production sites on time; drawback payments due to exporters are delayed for months or even years; and going through the multi-layered clearance process is very costly.

Tax distortions. To attract foreign investment, some countries use special investment incentives, including tax holiday's, tax credits and exemptions, and reduction of duties. However, experience shows that such strategies have had little, if any, impact on most long-term investors. Tax holidays create distortions of tax regimes; they favor new investors and discriminate against existing ones-in some countries, they discriminate against domestic investors. The expiration of tax holidays causes sudden increases in tax burdens on companies. Moreover, these incentives are often granted through complex and bureaucratic administrative procedures that encourage corruption. A stable, automatic tax system with reasonable rates and without discretionary incentives is better both for investors and for the host country. Many countries have a long way to go to reach that goal.

Getting the word out. Investment promotion--persuading investors to come--has become widespread in recent years. More countries, however, need to have a carefully planned program of making the improvements achieved at home known to the world-not so much through expensive advertising supplements but rather through sophisticated, long-term public relations campaigns. Providing elective assistance to interested investors and businesslike follow-up, and helping existing investors to solve administrative problems are important parts of promotion that are too often neglected.

Role of governments

For many countries that have not achieved the expected results, the problem is that reforms have been inadequate. Governments need to persevere with reforms already under way. Intensified global competition has put companies under greater pressure, and they are responding by investing only in the most favorable places. Countries should take this as a challenge rather than a threat if they want to win the battle for FDI.

Furthermore, policy liberalization alone may not increase competitiveness sufficiently. Economic opening is the necessary "stick" to force competition and shift resources to their most productive uses.

Experience in many countries suggests that "carrots"--public support of efforts to make firms more efficient--are also urgently needed. For example--now that international investors have begun to be more interested in high productivity than in low labor **costs**, government assistance is needed to upgrade technology and labor skills. Access to information and technical services, general education, and specialized industrial and managerial training are more important than ever.

"Public support" does not mean, however, that governments should do, or even pay, for it all. To the contrary, many of the support services required by industries are best delivered by private institutions. Foreign investors themselves can provide assistance, motivated by their own business interests. Private companies not only benefit from such a supporting system but also can play a crucial role in the design and operation of it, and they must bear at least part of the cost.

The role of governments is thus becoming more complex. Governments can no longer act simply as monopolies providing certain services or goods, or even simply as regulators; their functions must include those of organizer, coordinator, assistant, and partner. To succeed, governments will need to change their orientation and acquire new skills. Commitment, creativity, and willingness to learn from mistakes are crucial assets that can lead to success.

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